



EXECUTIVE SUMMARY

LIQUID ASSETS AND CONSUMER CREDIT ON THE HOUSEHOLD BALANCE SHEET

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The ability of a household to service its debts typically depends on the level and variability of current income flows in relation to payment obligations coming due. In addition, a household may judge its debt service capacity on the basis of the amount and liquidity of its financial assets. The purpose of this study is to investigate the extent to which households using consumer credit also hold liquid assets.

I. Definitions and Trends

Liquid financial assets are those that may be converted easily to cash with little if any price uncertainty. Liquid assets generally yield a low real rate of return but are held to meet emergency financial needs. Households are usually counseled to maintain liquid asset balances equal to between two and six months of after-tax income to cover living expenses in the event of unexpected interruptions in income or unexpected expenses.

The rate of return consumers can earn on liquid assets is normally lower than the unconstrained rate charge on consumer loans. Therefore, at the point in time when the decision to use credit is made, households have little economic incentive to borrow for consumption if they have sufficient balances to pay cash and still have liquid assets above some minimum "safety stock."

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The ratio of aggregate liquid assets to consumer instalment credit represents a "quick ratio" for the household sector, an indicator of the extent to which short term debts could be paid out of assets which could be converted easily to cash. Between 1963 and 1974, the aggregate relationship between liquid assets and consumer credit in the household sector was steady at about 450 percent. Then between 1979 and 1982, the measure spiked to 550 percent.

In 1983, when the cross-sectional data analyzed in this study were collected, households were holding more liquid assets relative to consumer debts than normal, as evidenced by the quick ratio. Since 1983 consumers have moved into less liquid assets, searching for higher yields on their savings. They have also saved less, investing more in durables that yielded a higher return than liquid assets. Additionally, maturities of auto loan contracts have increased since 1983, enabling consumers to borrow more while keeping monthly debt service obligations low. Finally, consumers who use credit have increased the amount of consumer debt used as interest rate ceilings were abolished in many states. These forces in combination caused the relationship between liquid assets and consumer debts in the aggregate household portfolio to return to a level close to the historical norm by the end of 1985. Therefore, this analysis does not provide a view of the ability of borrowing households to repay consumer debts by liquidating financial assets today. But the analysis does provide information about the financial management practices of debt-using households and the liquidity of households using credit cards for credit purposes.

II. Conclusions of Analysis

About two in five borrowers had liquid assets balances that were greater than the total of consumer credit owed, and less than one in ten borrowers had zero liquid assets. Most borrowers had some liquid assets but not enough to repay all debts. Highly liquid borrowers had a greater percentage of their total consumer credit in the form of revolving credit than less liquid borrowers. This suggests that the credit decision of highly liquid borrowers might have been based on convenience rather than a careful weighing of the cost of credit versus the opportunity cost of drawing down savings. Much of the instalment credit used by highly liquid borrowers came from banks and credit unions where such households might have had opportunities to borrow, using accumulated savings as collateral or to get a low price for credit because of a deposit relationship they had with the lender.

Turning to credit cardholders, 70 percent of households using the credit feature of credit cards in 1983 held enough accumulated liquid asset balances to pay off their total credit card balances. The balance of revolvers owed more on their credit cards than they held in total liquid assets. Such revolvers had high debt burdens in general, were more likely than more-liquid revolvers to report that they had been turned down for credit in the recent past, and were more likely to have less than a high school education.

The results of this analysis of the liquid assets held by households using consumer credit have several policy implications. First, historically, a significant percentage of households using consumer credit have owned relatively large liquid asset balances. Despite the enactment of Truth in Lending legislation, a large contingent of borrowers in 1983 maintained

liquid asset balances exceeding the amount they had borrowed for consumption purposes. Although it may not appear as economically rational behavior, many consumers apparently borrow money to avoid depleting accumulated liquid balances, especially if their credit needs are small.

Second, the credit card is priced as a source of credit to appeal to households with low liquidity who, as it turns out, also have high credit risk. However, most revolvers on credit cards are highly liquid relative to the amount owed on their cards. As yields on savings decline, the cost of revolving credit (assuming it does not decline with savings yields) for cardholders with liquid assets increases relative to their opportunity cost of drawing down liquid assets. Therefore, cardholders with ample liquid assets seek lower credit rates by engaging in more credit shopping or by supporting attempts to regulate rates. In the long run, the liquid borrower will not pay the same rate for credit that the borrower with no liquid assets is willing to pay. New products, segmentation strategies, or both will be developed by card issuers to retain the highly liquid borrower as the opportunity cost of drawing down liquid assets declines.

Finally, in discussions of the financial strength of households, many economists have viewed the increase in consumer credit outstanding relative to income with concern. Others have interpreted the high level of liquidity of the household balance sheet as a positive condition which should reduce concern about the ability of households to service their debts. But doubts were expressed about the overlap of borrowing households and households holding liquid assets. This analysis demonstrated that households using consumer credit frequently own large liquid asset balances (relative to credit owed). In fact, approximately 35 percent of liquid assets in this sample was held by the 50 percent of households that used consumer credit. Growth in

credit outstanding that results from reducing credit standards is likely to put relatively more credit on the balance sheets of low liquidity households. Thus, the 1983 data probably are not a faultless indicator of credit quality in 1986. However, a relatively stable proportion of consumer credit users, between 30-40 percent, maintain liquid asset balances sufficient to totally repay their consumer debts. Thus, this analysis supports the view that the debt service capacity for households has improved as the aggregate liquidity of the household sector increased. Further analysis is needed to understand the relationship between the liquidity of borrowers and the types and terms of consumer credit used.